

DEDUCTION IN COMPUTING PROFITS Expenditure wholly and exclusively laid out for the purposes of trade etc Purpose of expenditure Dual purpose Conversion of building society into listed bank - Advisory and other costs - Whether incurred for purposes of subsidiaries' trades No Whether incurred partly for non-trade purpose of releasing value to members - No - Whether incurred for non-trade purpose of protecting against take-over - No - Whether incurred for non-trade purpose of making members who were customers into shareholders - No - Income and Corporation Taxes Act 1988 s.74(1)(a)

DEDUCTION IN COMPUTING PROFITS - Capital or revenue expenditure - Capital withdrawn from trade - Conversion from building society to listed bank - Whether payments from advisory and other services capital or revenue expenditure - Revenue - Whether statutory cash bonuses capital expenditure - Capital - Appeal allowed in part - Income and Corporation Taxes Act 1988 s.74(1)(f)

THE SPECIAL COMMISSIONERS

WOOLWICH PLC Appellant

- and -

C DAVIDSON

(HM INSPECTOR OF TAXES) Respondent

Special Commissioners: STEPHEN OLIVER QC

DR A N BRICE

Sitting in public in London on 6-9, 14, 15, 20-22 March 2000

John Gardiner QC and Jonathan Peacock, counsel, instructed by Clifford Chance, solicitors, for the Appellant

Nicholas Warren QC and Rabinder Singh, counsel, instructed by the Solicitor of Inland Revenue, for the Respondent

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DECISION

1. On 7 July 1997 Woolwich plc became the statutory successor to Woolwich Building Society which "converted" to a bank under section 97 of Building Societies Act 1986 ("BSA"). Woolwich plc was a specially formed company. It succeeded to all the "properties, rights and liabilities" (to use the words of the Transfer Agreement) of Woolwich Building Society.

2. In this decision we use the terms Woolwich Building Society and Woolwich plc where we refer specifically to the activities, rights, liabilities etc of those two entities. Otherwise we use the term "the Woolwich" which refers to Woolwich Building Society until 7 July 1997 and to Woolwich plc thereafter.

3. The costs of conversion, which included "statutory cash bonuses" of some £5.7 million, amounted to some £74.3 million. Deductions have been made for this expenditure in computing the Woolwich's profits for tax purposes for the periods in which it was incurred. The Inland Revenue have disallowed the full amount as a deduction on the grounds that it is capital expenditure and that it was not incurred wholly and exclusively for the purposes of the Woolwich's trade. The Woolwich have appealed. We have been asked to resolve the issues as matters of principle leaving amounts to be agreed.

4. The appeals of four building societies were heard in succession. The decisions in the other three appeals are contained in the following reports -

Halifax plc v Davidson SpC 239

Northern Rock plc v Thorpe SpC 241

Alliance and Leicester plc v Hamer SpC 242

Evidence

5. Documentary evidence included -

Accounts of Woolwich Building Society and Woolwich Plc for the periods to which this dispute relates

Notices of assessment

Transfer Document issued to all members in pursuance of their requirements of the BSA

Transfer Agreement of 30 December 1996

The Stock Exchange listing particulars

Schroders' Strategic Review Paper of October 1994

Report of Director's Strategy Conference of October 1994

Directors' Strategy conference, October 1995

Board minutes of 5 December 1995 and of 3 January 1996

Minutes of Chairman's Committee of 18 September 1995

Press releases

Letters of engagement and invoices relating to services provided by lawyers, accountants, merchants banks, public relations advisers and stockbrokers

Communications with members and customers etc

Correspondence with Inland Revenue

Sample invoices etc.

6. Evidence relevant to the Woolwich appeal alone was given by -

(i) Donald Kirkham who had been Group Chief Executive of the Woolwich Building Society throughout the period leading to the Woolwich's decision to convert.

(ii) Lynda Blackwell, solicitor and assistant company secretary of the Woolwich

The evidence of Mr Kirkham was given in a witness statement and orally. References to his evidence recorded in the transcript are identified with day and page of the transcript (eg 11/20). The witnesses whose evidence applied to all four appeals (and whose particulars are given in the Halifax decision) were -

(i) Ronald McNeill Paterson FCA

(ii) Terence Mathews

(iii) Christopher Knight

(iv) T C Carne FCA

The disputed costs

7. The disputed costs, incurred during the 12 months to 31 December 1996, the period from 1 January 1997 to 7 July 1997 and for the period from 7 July 1997 to 31 December 1997, related to the steps required to implement the conversion process and payment of the statutory cash

bonuses. The event that triggered the conversion process was the decision in principle of the Board of Directors of the Woolwich Building Society on 3 January 1996 to recommend conversion at a time in the future to a public limited company registered as a bank. The services for which the costs were incurred are itemized in greater detail in the Halifax decision (paragraph 11) covered six main areas:

- (i) Corporate finance including due diligence work carried out by KPMG
- (ii) Legal and regulatory: this was carried out by Linklaters & Paines
- (iii) Register
- (iv) Logistics
- (v) Communications
- (vi) Treasury

Of the total expenditure of some £74.3 million, the following are the principal ingredients -

Staff and Staff-related costs £ 7.3 million

Literature/stationery/printing £ 1.7 million

Postage and mailing £12.1 million

Communications and advertising £ 7.9 million

Legal and advisory £25.2 million

Share registration/distribution £ 7.0 million

Statutory cash bonuses £ 5.7 million

Background

8. The introduction to the issue set out in the Halifax decision is applicable to the present decision.

9. The Woolwich was founded in 1847. It expanded by organic growth in the 19th and early 20th centuries from its original base in Woolwich and decided in the 1920s to open branches outside this immediate area. By 1947, the Woolwich was the third largest society in the UK with assets of £50 million. Its assets grew by 1955 to £116 million, by 1975 to £1,259 million and by 1995 to £28,000 million. During its life the Woolwich merged with a number of other societies, the most significant being the mergers

with the Property Owners in 1986, the Gateway in 1988 and the Town & Country in 1992.

10. From 1847 until 7 July 1997 the Woolwich was a "mutual" organization owned by its members. Its traditional activities, in common with all building societies, were restricted to raising funds from investing members and lending them to borrowing members to purchase their homes. The result was that the majority of customers of building societies were its members. However, in more recent times the Woolwich, in common with other societies, started to offer its customers other products and services which did not confer membership of the society.

11. Prior to conversion the Woolwich was still the third largest building society and was the fifth largest mortgage lender in the United Kingdom. It had 400 branches. In the year ended 31 December 1996 the amounts owing to it secured on UK mortgages were £22,961 million and UK "retail" deposits by the Woolwich's UK customers were £20,736 million. Its revenue surplus for that year was £331 million.

The Woolwich's core business

12. Under the guiding principle of providing "our customers with the services and products that meet their needs and are amongst the very best in terms of value, cost and range", the Woolwich Building Society and its subsidiaries were organized into three different business sectors. These were "lending", "investing" and "protecting".

- The "lending" business offered fixed and variable rate mortgage products primarily to residential purchasers. Mortgage lending was offered through the branch network and through the "Woolwich Direct" telephone service. In addition this part of the business included the Woolwich Building Society's personal loan and overdraft facilities, with £47 million outstanding at the end of 1996.
- The "investing" business included retail savings. This was made up of various savings products which included the Woolwich current account, the "Prime Gold" instant access account, deposit accounts, TESSAs and fixed rate and guaranteed growth products. Access to savings was offered via the Woolwich's "cash machines" or via reciprocal arrangements with other financial institutions. In addition the Woolwich offered a postal account through "Woolwich Direct".
- The treasury operation provided funding and liquidity, risk management, capital raising and active involvement in product development.

Those activities produced around 88% of total group profit in 1996 and they also amounted to around 95.6% of total group assets in 1996. The group pre-tax surpluses for the year to 31 December 1996 were £392 million and of these (as already noted) £331 million came from the building society operation.

Subsidiaries

13(1) Woolwich Life Assurance Company Ltd ("Woolwich Life") was a 90% subsidiary, being owned as 10% by Sun Alliance. It marketed mortgage-related products such as mortgage endowment policies and life assurance policies linked to repayment mortgages and critical illness cover. At 31 December 1996 its net asset value of £37.4 million was 0.13% of the net asset value of the group and its contribution to group pre-tax profits was 1.93%. It was regulated by the Department of Trade and Industry and the PIA.

(2) Woolwich Insurance Services Ltd ("WIS") provided mainly buildings and home content insurance cover. 70% of the Woolwich Building Society borrowers bought at least one insurance product from WIS. At 31 December 1996 its net asset value was £11 million, being 0.04% of the group net asset value, and its contribution to group pre-tax profits was 3.7%. It was regulated by the Department of Trade and Industry.

(3) Woolwich Unit Trust Managers Ltd offered simple unit trust products. At 31 December 1996 its net asset value of £3.2 million represented 0.01% of the group net asset value and its contribution to group pre-tax profits was 1.12%. It was regulated by the PIA and IMRO.

(4) There were two mainland Europe mortgage lending companies. These were Banque Woolwich in France and Banca Woolwich SpA in Italy. Both conducted mortgage lending activities. Banque Woolwich's net assets of £67.5 million were 0.23% of the group net assets at 31 December 1996 and its contribution to group profits was 2.55%. Banca Woolwich's net assets were 0.13% of the group net assets at that time and its contribution to pre-tax profits was 0.39%.

(5) Woolwich Guernsey Ltd, a Channel Islands deposit taker located there to raise funds from British expatriates and others, represented 0.14% of the group net asset value and its contribution to group pre-tax profits was 2.45%.

(6) Woolwich Property Services Ltd ("WPS") provided residential estate agency services. It was, explained the Listing Particulars, an important channel for obtaining mortgage and life assurance business. A marketing ploy was to provide no-fee arrangements in which sellers would pay no estate agency fees if they took out a Woolwich

mortgage on their new property. WPS contributed 0.68% of pre-tax profits for the year to 31 December 1996 and it represented "minus" 0.07% of the group net asset value.

Supervision

14. The Woolwich, was regulated by the Building Societies Commission until 7 July 1997. Prior to conversion it was governed by a 14-strong board of directors made up of a chairman, four executive directors and nine non-executive directors who met monthly or more frequently.

Regulatory position under Building Societies Act 1986

15. This is summarized in paragraphs 21 and 22 of the Halifax decision. It is not in dispute that the Woolwich was affected by the same regulatory constraints as were regarded by the Halifax board as restricting their opportunities to react to competition and develop new projects and products.

The growth of competition

16. These factors are substantially the same as affected the Halifax: see paragraphs 23-25 of the Halifax decision (SpC 239).

Events leading to conversion

17. The Woolwich first considered the option of conversion in the late 1980s. The then board of directors held a series of meetings to discuss the advantages and disadvantages of conversion in the light of the then regulatory and competitive position. A decision was made at that time to remain mutual. The matter was discussed by the board at various times after that.

18. In 1994 the issue of conversion was formerly considered by the directors of the Woolwich as part of a wider strategic review of its business. At this stage Schroders (merchant bank) were retained to advise on overall strategy. They provided a Strategic Review Paper, and a "Defence File". The Strategic Review assessed the respective advantages of remaining mutual, of conversion to a Plc and of merging with another society possibly followed by conversion. The review was conducted on the assumption that the board of the Woolwich would wish to see it grow and diversify. It saw retention of mutuality as the appropriate course should the Woolwich decide to adopt a "niche" strategy concentrating on its core products without much growth and diversification. It commented that if the Woolwich wished to return cash to its members, it could achieve this by ad hoc changes to its margins. Conversion, the Review suggested, would give the Woolwich wider powers and access to greater capital which might put it in a better position to respond to changes in

the market. Observing that flotation would be disruptive and a time consuming process, it commented that this course would crystallize value for members and would (if the specially formed company route were adopted - see the Halifax decision paragraph 29) secure protection for the Woolwich from takeover or merger for five years. Merger would enhance the size of the Woolwich and its geographical spread. The Review commented however that this would not broaden its product base nor would it crystallize significant value for members unless it were coupled with a commitment to convert in due course. On 23 October 1994 the board held a meeting at which the various options were discussed.

19. Further consideration of the conversion option took place at the Directors' Strategy Conference held on 29 and 30 October 1995. The matter was again considered in detail at the board meeting of 5 December 1995. At that meeting the board rejected the option of retaining mutuality. This was believed to be no longer appropriate for the Woolwich and its members and staff and it was felt that it would impede the Woolwich's ability to provide a full range of competitively priced personal financial services to customers. The board agreed that conversion to a specially formed company afforded the best prospect.

20. On 3 January 1996 the directors formally determined to convert to plc regulated as a bank. In the course of their discussions they rejected the option of staying mutual observing that, if they were to do so and to make "mutuality distributions" to its members this would provide little value to them. Moreover mutuality bonuses would reduce the amounts of reserves and hence, of capital available for diversification. The Board minute records as the fundamental rationale for taking the decision to convert the following factors -

- "Conversion would release value through a distribution to qualifying members
- Conversion would separate the equity shareholder (the owner) from the customer, resulting in a clearer and more accountable relationship than existed in a society.
- Additional capital could be used to make acquisitions, if necessary, in a more forceful way, in order to fulfil the underlying strategic objectives of business and geographical diversification.
- The company which had access to equity finance had greater flexibility to fund business expansion and development programmes
- Banks were subject to a more permissive legislative regime, whereas building societies currently operated under a restrictive legislative regime. Conversion would

consequently afford greater and more rapid operational flexibility, together with greater access to wholesale money markets and "conversion would offer greater opportunities to employees for new and more rewarding employment and career prospects.

Required steps leading to conversion

21. Paragraphs 26 to 35 of the Halifax decision, reading in changes where appropriate, are equally applicable to the conversion of the Woolwich Building Society to Woolwich Plc.

Appointment of advisers

22. The Woolwich appointed the following professional advisers to advise on the planning and implementation (particularly the necessary regulatory steps) of the conversion project -

- Schrodgers (corporate finance) were engaged on 4 March 1996 to advise the Board on the terms and timing of conversion, to assist in negotiations with the regulators, to advise on the flotation process, to assist in the preparation of the Transfer Document, to instruct KPMG in the preparation of an accountants' report, to advise on capital structure, to advise on the transfer of shares from members to institutional shareholders and to provide strategic and financial advice.
- Linklaters & Paines (legal) were engaged to provide all necessary legal advice on the conversion process.
- BZW (broking) were engaged on 30 March 1996 to provide strategic and markets advice in preparation for flotation, to organize the investor marketing programme, to assist in the preparation of all marketing documentation and to provide full corporate broking services. In addition BZW undertook to provide an order-taking facility to execute sales of shares by members immediately on flotation to institutional purchasers.
- R E Savage & Associates were engaged on 3 April 1996 to provide general management consultancy services relating to the conversion.
- British Telecom Plc were engaged to set up the special line, recruit and train operators, configure all necessary systems, provide additional accommodation and infrastructure to handle volumes of calls and provide daily reports to the

Woolwich.

- KPMG were engaged to provide general financial and accounting advice on conversion, to provide the statutory reports for the Bank of England, to produce a report for the London Stock Exchange and to report on the financial information contained in the Transfer Document. As well as that they provided tax advice, assisted with the programme of de-duplication of records, assisted in the preparation of the members' register and audited the accounts for the relevant period.
- A programme manager was engaged for the "Conversion Project Officer".
- A public relations consultancy (Dewe Rogerson) was engaged to provide consultancy services on press coverage and to handle the media.

Internal organization framework

23. Lynda Blackwell explained how the steps to conversion were progressed. The Woolwich established a board sub-committee (the "Chairman's Committee") to oversee the project. Answerable to this was a project sponsor and a project board. The process was broken down into five "sub-projects". These were (1) finance and planning, (2) legal, (3) communication, (4) secretarial and logistics and (5) "changed management". Each had its own manager and its own budget.

The formal steps in the conversion

24. The conversion was achieved under BSA section 97. Five main steps were

involved -

(i) The Woolwich Building Society subscribed cash for shares in a newly formed company, the Woolwich plc.

(ii) The Woolwich Building Society entered into a Transfer Agreement dated 30 December 1996 with Woolwich plc under section 97 conditional on member and regulatory approval. In April 1997 the members approved the transfer (and conversion) at a special general meeting.

(iii) On "vesting day", 2 July 1997, the Woolwich Building Society transferred its business to Woolwich plc.

(iv) The Woolwich Building Society distributed its shares in Woolwich plc to its members and paid the statutory cash bonuses and

(v) The Woolwich Building Society was dissolved.

Under the terms of the Transfer Agreement the business of The Woolwich Building Society was transferred and vested in Woolwich plc "as if, in all respects, the (Society) and (Woolwich plc) were the same person in law".

Post conversion events

25. As a result of instructions given prior to the Vesting Day, some 568,000 new shareholders sold their shares at the weighted average price of 296.5p and by the end of 1997 the Woolwich Plc had 1.4 million shareholders.

26. In accordance with section 102(2)(b) BSA the Woolwich paid statutory cash bonuses of £5.7 million to members not entitled to distributions of shares.

27. On 7 July 1997 the Bank of England formerly authorized Woolwich Plc under the Banking Act 1987. See paragraph 42 of the Halifax decision.

The wholly and exclusively issue

28. Income and Corporation Taxes Act 1988 section 74(1)(a) and the relevant judicial propositions are set out in paragraph 43 of the Halifax decision.

29. The case for the Inland Revenue is that the Woolwich's conversion expenditure fails the wholly and exclusively test on four grounds. First, it is argued, the expenditure was incurred by the Woolwich Building Society wholly or partly for the purposes of benefiting the existing or future trades of other group companies, i.e. their subsidiaries. Second, the expenditure was incurred wholly or partly for the purposes of releasing value to members. Release of value, it is argued, was a reason for the conversion and not simply a consequence of it. Third, it is argued, the expenditure was incurred wholly or partly for the purposes of avoiding a takeover. Woolwich Plc had been formed for the purposes of the conversion. As such it was protected for five years by reason of BSA section 101 which required the insertion of protective provisions in its Memorandum and Articles of Association. Fourth, it was argued, the expenditure was incurred partly to resolve the "constitutional" problem that arose because some customers were members whereas others were not. The problem was cured by making the former shareholders. The problem related to the proprietorship of the trade; consequently the expenditure was not incurred for the purposes of earning profits in the

trade.

30. The Woolwich argued that all the expenditure was incurred wholly and exclusively for the purposes of its single and continuing trade.

31. Our approach to this issue has been to concentrate on three primary sources of evidence, namely the Transfer Document and any supporting papers, the board discussions and the witness statement and evidence of Mr Kirkham. We shall start with a summary of the Transfer Document so far as it leads to recommending conversion. Then we will take each of the Inland Revenue's contentions in turn.

The Transfer Document

32. Section 3 is headed "the Background to the Proposals". This is introduced by the following words:

"This is one of the most important Sections in this document. It explains why the Board has taken the decision in favour of Conversion and is unanimously recommending that you approve the Transfer of the Business of the Society to Woolwich Plc. It explains why the Board felt that change was necessary, all of the strategic options which were considered and why the Board considered that Conversion and Flotation are in the best interests of the Woolwich, its Members, its other customers and employees."

33. Paragraph 3.2 reviews the strategic objectives of the Woolwich identifying these as to build on its market position and its core businesses of mortgage and deposit-based savings, to strengthen its position in its other chosen markets such as life assurance, unit trusts and personal loans, and to become more cost-effective, spreading costs over a greater number of customers.

34. Paragraph 3.3 refers to the "Development of the Woolwich". It explains that the Woolwich is a diversified building society with activities closely allied to its core businesses such as money transmission services, financial advice and estate agency. It emphasises that it was the first building society to set up a captive insurance company for underwriting mortgage indemnity guarantee insurance.

35. Paragraph 3.4 recognizes, among other things, the intense competition with other financial services providers faced by the Woolwich.

36. Paragraph 3.6 contains the reasons for rejecting the options of, first, remaining a building society and, second, merging with another building society. BSA constraints and their effect on the Woolwich's ability to make responses to developing areas of business are one reason. Limitations on

access to external capital markets including the impossibility of obtaining access to equity capital markets are identified as another. The "perceived tensions" in relation to different classes of customers are identified as another reason; the text reads -

"Finally, remaining a building society would not allow the Woolwich to resolve perceived tensions in relation to different classes of customers, in particular those who are members of the building society and those who are not members such as depositors in Woolwich Guernsey Ltd, life assurance policy holders and unit trust holders. As a result of expanding our activities beyond the traditional business of mortgages and savings, an increasing number of the Woolwich Group's customers eased purchasing products and services which do not confer the right to be a Member of the society."

The paragraph records that the board have considered and rejected "mutuality bonuses" (i.e. recurrent payments made to members of a mutual building society) and merger.

37. Paragraph 3.7 sets out the "fundamental rationale" for conversion. This repeats some of the points identified by the Board as reasons for reaching their decision to recommend conversion at the meeting of 3 January 1996. The factors are as follows -

- Access to additional equity capital providing greater flexibility to fund business expansion and development.
- The legislative regime governing banks which would afford greater operational freedom together with more flexibility in the use of wholesale money markets.
- Value would be released to members through a distribution of shares or cash or a mixture of both.
- With a share distribution, conversion would separate the equity shareholder (the owner) from the customer, allowing members to choose whether to remain both a customer and a shareholder and
- Conversion would offer greater opportunities to employees.

38. Paragraph 3.9 explains the implications of conversion and flotation. It points out that the Woolwich would become one of the top ten UK banks in terms of total asset size and it would be included in the Financial Times - Stock Exchange 100 Index. By converting to a plc on its own, it is noted, the Woolwich should be able to retain control over the pace and extent of its business development, subject to external market conditions and to the requirement to satisfy the expectations of its shareholders for profitable

growth. In addition, it is said, conversion through the specially formed company route would prevent any shareholder acquiring more than 15% of the company for a period of five years from 7 July 1997.

39. The Board's "conclusions and recommendations" are set out in paragraph 3.10. This reads -

"We have decided that the Transfer and Flotation are in the best interests of the Woolwich, its Members, its other customers and its employees. In our view, this option gives the Woolwich a corporate structure which would allow it to meet its strategic objectives by remaining an independent provider of a wide range of personal financial services and by maintaining its strong culture and values founded on excellent customer service, organizational effectiveness and innovation. In addition, this option provides Members with the opportunity of an ongoing interest in the very successful business to which they have contributed over the years."

40. It is not in dispute that the expenditure incurred by the Woolwich to secure conversion ranked as expenditure incurred for the purposes of its trade. The issue is whether it was expenditure laid out "wholly and exclusively" for the purposes of the trade. We turn now to examine the four grounds on which the Inland Revenue challenged the expenditure.

Ground 1: benefiting the subsidiaries. Were the conversion costs incurred partly for the purposes of the activities of the subsidiaries?

41. The Inland Revenue contend that a purpose of the conversion and consequently a purpose of incurring the disputed expenditure was to benefit the subsidiaries. At the time when the Board were considering conversion the BSA and regulations made under it required that the assets and liabilities of subsidiaries carrying on lending and borrowing activities had to be aggregated with those of the building society itself in determining whether it was within the permitted "nature" limits (see paragraph 21 of the Halifax decision). For this purpose intergroup liabilities and assets are left out of account. It followed that the regulatory constraints imposed upon the Woolwich Building Society by the BSA and the regulations affected not just the building society but also Banque Woolwich and Banca Woolwich; release from those constraints stood to benefit those two companies in the sense that it enabled them to become more competitive and to react more speedily to business opportunities.

42. As will have been noted, the Transfer Document does not refer to benefiting the subsidiaries as a rationale for the recommendation to convert.

43. The Schrodgers' Strategic Review (page 70), produced for the Strategic Review Conference of October 1994, observed, under the heading "overseas developments" -

"To enhance the competitive performance of these companies, and hence Woolwich, the development of these European subsidiaries could be accelerated with new capital".

Mr Kirkham had said of these two companies that they had been separately incorporated on account of local regulations and that they had stood to obtain no benefit from conversion. At the time that conversion was being considered, Mr Kirkham said, the thinking had focused on the problems that they had at home where 90% of their profits came from and 99.5% of the net assets were. It was suggested to Mr Kirkham in cross-examination that consideration had been given to the position of subsidiaries as a result of conversion and his response (11/146) was -

"I do not think it was. The subsidiaries were light years away from causing any pressures on the actual structure of our balance sheet, either in terms of nature limits, in terms of demand for capital, in terms of funding. The subsidiaries, then they were not insignificant. Now, they are still nothing but a tail. They are not going to wag the dog and did not and it was no material part of our thinking."

In his view the sole motivation for conversion was the freedom that the corporate "bank" form offered vis-à-vis the corporate form of a building society (11/147).

44. We do not consider that the disputed expenditure was incurred for the purposes of the two banking subsidiaries. The highest that can be said for the Inland Revenue's case is that, while Woolwich Building Society remained a building society, there was a theoretical possibility that the mainland Europe banking subsidiaries' borrowings could affect the limits imposed on Woolwich Building Society's wholesale borrowings; and once Woolwich had converted it would have unlimited access to wholesale funds to onlend to those subsidiaries. It was only to be expected that the papers produced for the October 1994 Strategic Review Conference should have explored the implications of conversion on the subsidiaries. We accept Mr Kirkham's evidence that the businesses of those subsidiaries were barely contemplated as possible beneficiaries of conversion. This follows we think from the fact that their contributions to group pre-tax profits and to group net asset values (see paragraph 13 above) were very small indeed and that it would have been a long time before their liabilities had any possible impact on the Woolwich's borrowing (nature) limit. The affairs of those two subsidiaries were so low in the priorities of those taking the decision to recommend conversion that the benefits to their trades cannot, we think, be said to have been "so inevitably and inextricably

involved" in the conversion expenditure that "they must be taken to be a purpose for which payment was made" (see Millett LJ's fourth proposition in Vodafone Cellular at page 742).

45. So far as the other subsidiaries were concerned, the Inland Revenue focused on possible benefits arising from conversion that could be enure to the WPS (the estate agency business), to Woolwich Life, to WIS (insurance services) and to the captive insurance company referred to in the Transfer Document. Mr Kirkham pointed out (11/84) that neither WPS, WIS or Woolwich Life made any demands on the Treasury function of raising wholesale funding. We accept this. WPS in particular had been funded out of existing reserves. Setting up the captive had called for a considerable amount of explaining to the Building Societies Commission: Mr Kirkham accepted that the "irritant" factor caused by the Commission would be removed following conversion (11/112). We note however that none of these subsidiaries were subject to the regulatory regimes imposed by the BSA. They had their own regulators. Consequently conversion could have had no direct effect on their activities. For those reasons nothing in the circumstances of those subsidiaries gives us any grounds to conclude that benefiting their businesses was a purpose of the expenditure. Nor do we see the expenditure as having been laid out even partly for the purposes of the Woolwich's non-trading "activity" as a holding company.

Ground 2: release of value. Was the expenditure incurred wholly or partly for the purposes of releasing value to members?

46. "Value to members" was a factor expressed in the Transfer Document to have been taken into account by the board. Following its rejection of the option of staying mutual and providing mutuality bonuses, the Transfer Document, in paragraph 3.6, states -

"We also concluded that more tangible value would be released to Members if they received an initial allocation of Free Shares, allowing them an ongoing interest in the prosperity of the Woolwich's business through dividend receipts and changes in the market value of the shares they received."

"value to members" is the third of the fundamental reasons for conversion (see paragraph 37 above). The expression "value to members", Mr Kirkham explained, had been an internal project code used for reasons of secrecy. It had been first adopted in the summer of 1995, well before the decision to convert had been taken.

47. The Schrodgers' Strategic Review Paper (in paragraph 4.4) identifies value to members as an issue to be confronted, without any recommendation. The "Project Plan

for Conversion" (produced by two of the Woolwich management personnel for the October 1995 Strategic Conference) refers to the "project mission" as the "VTM Project" without elaborating on this. A paper for the Board Meeting of 5 December 1995 examined the "distribution options" and provided the Board with a proposed "Share Distribution Scheme" including statutory cash bonuses. The Board Meeting of 3 January 1996 approving the proposal to convert identifies "release of value" as the first "fundamental rationale for conversion": see paragraph 20 above.

48. We note that, apart from the statutory cash bonuses, the effect of conversion was not to release value to members at the expense of the Woolwich Building Society. The Woolwich Society paid out nothing to the members. Conversion had the effect of redefining the members' rights in the corporate entity. From being a remote future interest in the building society's reserves, the member becomes a shareholder with a direct participation in reserves.

49. Mr Kirkham's evidence which was not challenged was that it had not been any purpose behind their decision to convert to put cash into the hands of their members. There had, he said, been three reasons for this. First, the decision to convert had been made for sound business reasons and not with the aim of providing any form of windfall to members. Secondly, he said, they had been advised by Slaughter & May through Schroders during the Strategic Review of October 1994 that consideration of the financial interest of their current members and putting cash in their hands was not a factor that they should be taking into account in deciding to convert. Thirdly, he said, (and this we have already noted) they did not transfer cash to their members save in the shape of statutory cash bonuses.

50. Mr Kirkham was pressed to explain why value to members had figured as the third feature in the "fundamental rationale" for conversion. He responded that the Board's decision had been based on business requirements; this had been the effect of legal advice. The real reasons for recommending conversion had been because, first, the regulatory regime laid down by and under the BSA had been hampering the Woolwich's ability to carry on its core mortgage lending and personal savings business and, the second, access to the wholesale money markets had been severely restricted for building societies like the Woolwich. The consequence of the decision had been to make what he called a "rights issue" (11/186). The important thing was getting the required number of members to vote; that had had to be considered once the conversion issue had been decided on business grounds. Hence the prominence given to "value to members" in the Transfer Document (11/195-6). Finally in this connection there had, Mr Kirkham told us, been no pressure from

members to convert (11/164-5).

51. Releasing value to members was, we think, an inevitable consequence of the decision to recommend conversion. It in no way motivated the board's decision. We are satisfied from the evidence as a whole that it was not a purpose for which the conversion expenditure was incurred.

52. The statutory cash bonuses were paid because the board had decided to recommend conversion and the members had voted in favour of this course. They were another inevitable consequence of the decision to convert. They were in no sense a purpose for which the expenditure was incurred. The business advantages sought from the new regime following conversion were the really significant factors motivating the decision to convert and paying the statutory cash bonuses was, as we have observed, an inevitable consequence of that decision.

Ground 3: protection against takeover. Was the conversion expenditure incurred wholly or partly for the purposes of avoiding a takeover of the Woolwich?

53. We can find no evidence of any substance that this was a reason or purpose of the Board in recommending conversion. It is certainly not stated as one of the relevant factors in the "rationale" in the Transfer Document.

54. BSA section 101 requires a society converting by the specially formed company route to include in its successor's Articles of Association protective provisions, which cannot be altered, prohibiting it from registering any transfer of shares resulting in a shareholder obtaining an interest of 15% or more for a period of five years from the vesting date. There is one exception to this rule which allows the Bank of England, at its discretion, to permit such a transfer if it deems it to be in the interest of depositors. This clause is designed to permit a rescue if the successor company is in financial difficulties. The Inland Revenue's argument was that the preservation of independence and protection against an unwanted takeover were purposes for which the expenditure was incurred and were not purposes of the trade, even though these might have been perceived by the board as in the interests of the Society and by its members and employees as advantages.

55. Mr Kirkham observed that the Woolwich was thought to be more vulnerable to takeover after it had made its decision to convert and announced the decision publicly. But a fear of takeover played no part whatever in any of the considerations surrounding the decision to convert. The history, culture and size of the Woolwich in the 1990s made it highly unlikely that an unwelcome bidder would attempt to "swallow" the Woolwich (to use his words). By contrast it had been the Woolwich's desire to put itself in a position whereby it could fund future growth through acquisitions of

suitable businesses. These factors had been considered in some detail at their Strategy Review Conference in 1995. He also observed that had the Woolwich board received a formal bid approach prior to conversion, they would have had to have examined it in the light of what they perceived to be the best interests of the business as a whole. They had never regarded independence as a goal in itself. Mr Kirkham's viewpoint was not challenged in cross-examination.

56. We accept that expenditure incurred on preserving independence could, in appropriate cases, be regarded as a non-trade purpose on the grounds that it was incurred to benefit the proprietors and not the trade. Nonetheless, we are satisfied that the expenditure here was not incurred for the purpose of avoiding a takeover or loss of independence.

57. We mention in this connection that we have looked at and taken into consideration the contents of "Woolwich defence file". This was produced by Schroders in July 1994. The purpose was to prepare the Woolwich Building Society as fully as possible should there be an "unwelcome approach". One of the five themes identified as an "active defence strategy" to be considered by the board "in the face of a stronger bidder" was conversion and flotation under the specially formed company route. The defence file recommends (in paragraph 5.4) that this area be the subject of further work. When, following the board's decision to convert (on 3 January 1996), further work was done, there was no background of unwelcome approaches; and, as we have just observed, fear of takeover played no part in the board's consideration. The earlier compilation of the defence file had, no doubt, been a sensible precaution. But its existence in no way persuades us that the later decision to convert and to incur the disputed expenditure was for the non-trade purpose of creating a five-year fortification against possible takeover. Nor are we persuaded that that should be regarded as a Mallalieu purpose.

Ground 4: Was the disputed expenditure incurred partly for the non-trade purpose of resolving the perceived tension between members who were

customers and customers who were not members?

58. The Transfer Document, as noted, stated that this had been one of the "fundamental" reasons for conversion. Mr Kirkham explained the background to the problem. The increase in the range of activities carried out by the Woolwich had produced a situation in which a large number of customers were not members. Under mutuality, only their customers in relation to their most traditional products such as mortgages and "share" accounts were members. It was only those customers who were entitled to be regarded as owners and to whom the board owed fiduciary duties.

Moreover, he pointed out, the board owed that duty to those members without discriminating as between different groups of them and in particular, without distinguishing between those who are members by virtue of one relationship, such as a mortgage account, and those who are members by virtue of a series of transactions with the Woolwich, such as a mortgage account and several savings accounts. Different groups of customers had different interests depending on the volume and type of business that they conducted with the Woolwich Building Society. The tensions became more aggravated as the non-member customers grew in number. At times of intense competition, such as existed in the 90s, management was pre-occupied with attracting profitable business and making the most of it; this, said Mr

Kirkham, had not been consistent with treating members more favourably than non-members nor with treating all members alike regardless of the size or value of the business they contributed. The attraction of abandoning the mutual form was, Mr Kirkham said, that they were able to shed their obligations to members and instead

deal with the different groups on normal marketing and contractual basis without struggling to maintain an artificial equity between them.

59. Under cross-examination Mr Kirkham insisted that this was a feature of mutuality that "was getting in the way of effective business" (11/152-3).

60. We accept Mr Kirkham's evidence. The "perceived tensions" between the interests of customers who were members and those who were not was an impediment to the carrying on of the business of the Woolwich Building Society; the board needed to be free to develop and market financial services products to customers at large without overriding the interests of those customers who happened to be members. An effect of taking and pursuing the decision to convert was that members had the opportunity to become and remain shareholders. This was what the Inland Revenue asked us to regard as a "constitutional" problem that conversion and issue of shares resolved. But the really significant factor about the board's decision to recommend conversion was, we think, that it was designed to remove that, among other, problems. Issuing shares was a means to the end but was not the end in itself.

61. For those reasons we think that to the extent that the expenditure was incurred to resolve the "perceived tensions" it was incurred wholly and exclusively for the purposes of the Woolwich's trade or business. Overall the evidence satisfies us that all the disputed expenditure, including the statutory cash bonuses, was incurred wholly and exclusively for the purposes of the Woolwich's trade.

We are therefore against the Inland Revenue on the "wholly and exclusively" issue.

The capital or income issue

62. For the reasons given in the Halifax decision we do not consider that the expenditure, other than the statutory cash bonus payments, was of a capital nature. It is not therefore excluded from deductibility either on general principles or by operation of Income and Corporation Taxes Act 1988 section 74(1)(f). The expenditure incurred in paying the statutory cash bonuses (some £5.7 million) is, for the reasons given in the Halifax decision, excluded from deduction both on general principles and as being "capital withdrawn from ... the trade" : section 74(1)(f).

Conclusion

63. The appeal is allowed in part. All the disputed expenditure, other than that incurred in paying the statutory cash bonuses, is allowable as a deduction in computing the Woolwich's profits for corporation tax purposes.

STEPHEN OLIVER QC

DR A N BRICE

SPECIAL COMMISSIONERS

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